From:	Avi Tiomkin <atiomkin@atglobalcap.com>
To:	Nili Priel <nilipr@netvision.net.il> ehbarak <ehbarak1@gmail.com>
CC:	Avi Tiomkin <atiomkin@atglobalcap.com>
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Paul Krugman: Killing the Euro
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By PAUL KRUGMAN
(New York Times) -- Can the euro be saved? Not long ago we were told that the worst possible outcome was a Greek default.
Now a much wider disaster seems all too likely.
True, market pressure lifted a bit on Wednesday after central banks made a splashy announcement about expanded credit lines (which will, in fact, make hardly any real difference). But even optimists now see Europe as headed for recession, while pessimists warn that the euro may become the epicenter of another global financial crisis.
How did things go so wrong? The answer you hear all the time is that the euro crisis was caused by fiscal irresponsibility.
Turn on your TV and you're very likely to find some pundit declaring that if America doesn't slash spending we'll end up like Greece. Greeeeeece!
But the truth is nearly the opposite. Although Europe's leaders continue to insist that the problem is too much spending in debtor nations, the real problem is too little spending in Europe as a whole. And their efforts to fix matters by demanding ever harsher austerity have played a major role in making the situation worse.
The story so far: In the years leading up to the 2008 crisis, Europe, like America, had a runaway banking system and a rapid buildup of debt. In Europe's case, however, much of the lending was across borders, as funds from Germany flowed into southern Europe. This lending was perceived as low risk. Hey, the recipients were all on the euro, so what could go wrong?
For the most part, by the way, this lending went to the private sector, not to governments. Only Greece ran large budget deficits during the good years; Spain actually had a surplus on the eve of the crisis.
Then the bubble burst. Private spending in the debtor nations fell sharply. And the question European leaders should have been asking was how to keep those spending cuts from causing a Europe-wide downturn.
Instead, however, they responded to the inevitable, recession-driven rise in deficits by demanding that all governments - not just those of the debtor nations - slash spending and raise taxes. Warnings that this would deepen the slump were waved away. "The idea that austerity measures could trigger stagnation is incorrect," declared Jean-Claude Trichet, then the president of the European Central Bank. Why? Because "confidence-inspiring policies will foster and not hamper economic recovery."
But the confidence fairy was a no-show.
Wait, there's more. During the years of easy money, wages and prices in southern Europe rose substantially faster than in northern Europe. This divergence now needs to be reversed, either through falling prices in the south or through rising prices in the north. And it matters which: If southern Europe is forced to deflate its way to competitiveness, it will both pay a heavy price in

employment and worsen its debt problems. The chances of success would be much greater if the gap were closed via rising prices in the north.

But to close the gap through rising prices in the north, policy makers would have to accept temporarily higher inflation for the euro area as a whole. And they've made it clear that they won't. Last April, in fact, the European Central Bank began raising interest rates, even though it was obvious to most observers that underlying inflation was, if anything, too low.

And it's probably no coincidence that April was also when the euro crisis entered its new, dire phase. Never mind Greece, whose economy is to Europe roughly as greater Miami is to the United States. At this point, markets have lost faith in the euro as a whole, driving up interest rates even for countries like Austria and Finland, hardly known for profligacy. And it's not hard to see why. The combination of austerity-for-all and a central bank morbidly obsessed with inflation makes it essentially impossible for indebted countries to escape from their debt trap and is, therefore, a recipe for widespread debt defaults, bank runs and general financial collapse.

I hope, for our sake as well as theirs, that the Europeans will change course before it's too late. But, to be honest, I don't believe they will. In fact, what's much more likely is that we will follow them down the path to ruin.

For in America, as in Europe, the economy is being dragged down by troubled debtors - in our case, mainly homeowners. And here, too, we desperately need expansionary fiscal and monetary policies to support the economy as these debtors struggle back to financial health. Yet, as in Europe, public discourse is dominated by deficit scolds and inflation obsessives.

So the next time you hear someone claiming that if we don't slash spending we'll turn into Greece, your answer should be that if we do slash spending while the economy is still in a depression, we'll turn into Europe. In fact, we're well on our way.

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